Myth: The Earned Income Tax Credit (EITC) is a tax.
BY EXPANDING THIS EARNED-INCOME TAX CREDIT TO WORKING FAMILIES

AND ESPECIALLY TO THE WORKING POOR

THIS CONGRESS HAS MADE HISTORY BY ENABLING US TO SAY FOR THE FIRST TIME NOW

IF YOU WORK HARD AND YOU HAVE CHILDREN IN YOUR HOME AND YOU SPEND 40 HOURS A WEEK AT WORK,

YOU CAN BE A SUCCESSFUL WORKER AND A SUCCESSFUL PARENT.

AND YOU WILL BE LIFTED OUT OF POVERTY. [APPLAUSE]
Most policy analysts believe that the Earned Income Tax Credit (EITC) substantially reduces poverty and increases employment in an administratively efficient and well-targeted way.¹ This is not true.

In this paper, I show that simple mismeasurements have greatly overstated the efficiency and effectiveness of the EITC program.
The EITC is a refundable tax credit that is paid once a year to families based on how many children they live with and how much income they earned in the prior year. The EITC is a trapezoid program, meaning that, as earnings increase, benefit amounts initially increase, then plateau, then decrease.

**Earned Income Tax Credit for Single Filer (2018)**

**Earned Income Tax Credit for Married Filer (2018)**
This trapezoid design serves three main ideological and policy purposes.

**Depriving the undeserving poor.**
By excluding those with very low earnings from the benefit, the EITC design ensures that money is only paid to families who are deemed deserving because of their level of work activity.

**Increasing work.**
By phasing in the benefit so that every unit of work is matched with an extra unit of benefits until the plateau, the EITC design rewards and increases work.

**Efficiently reducing headcount poverty.**
The trapezoid structure ensures that the program does not “waste” very much money on families who are too poor to be lifted over the poverty line or on families who are already above the poverty line. By concentrating the benefits on those just below the poverty line and using the IRS tax-filing infrastructure to administer the benefits, the EITC design achieves a substantial reduction in headcount poverty for relatively little money and with a low administrative overhead.

These three features have made the program attractive to many policy donors and policy analysts who have in turn convinced Democratic lawmakers to propose a seemingly endless number of EITC expansions and EITC copycat programs, including, in recent years, the RISE Act, the LIFT Act, the GAIN Act, and the Working Families Tax Relief Act.²
Mismeasuring the EITC

This case for the EITC is built almost entirely upon mismeasurement. When correctly measured, the EITC does not increase work, does not have a low administrative overhead, and only reduces headcount poverty by half as much as is currently believed. Upon scrutiny, the only piece of the pro-EITC case that remains is the morally repugnant point that the EITC is good because it excludes the undeserving poor.
The theory that the EITC increases work among populations who stand to benefit from it is fairly straightforward. A single mother with two kids receives 40 cents of EITC benefits for every dollar she earns up to the benefit plateau. This effectively turns her $7.25/hour minimum wage job into a $10.15/hour job. This higher effective wage thus acts as an enticement for her to take a job and to work more hours in the job she takes.

This theory makes sense on paper, but is undermined by practical problems. For individuals to respond to enticements, they have to be aware that they exist and have to understand how they work. Yet the EITC is designed in a way that makes this kind of comprehension very difficult.

Unlike in the stylized example above, EITC benefits are not actually tacked on to a person’s wages, but are instead paid out as a lump sum during tax time of the subsequent year. The gap between when income is earned and when the EITC benefit arrives can be more than 16 months, making it hard for people to intuitively connect the two.

Unlike more conventional welfare programs, the EITC benefits are hidden in the tax code. There is no government office where you apply for the EITC. There is not even a separate application for the EITC. Instead, in the process of filing a normal tax return, EITC benefits are discreetly added to an individual’s tax refund. Their EITC benefit is thus mixed in with other refund amounts, such as overpayment amounts and Child Tax Credit amounts, and is difficult to distinguish from the kinds of tax refunds that anyone else receives. This lack of conspicuousness makes it hard for people to realize that the program even exists.

Surveys of low-income families show widespread ignorance of the program’s existence and even more widespread ignorance of key details about how the program works. In one study, only 58 percent of low-income families claim to “have heard about the EITC” and, in another, virtually none of the families interviewed were aware of the fact that you need to earn a certain amount of money to maximize the amount of the credit received.3
Not surprisingly, careful studies of the EITC have shown that it does not cause more people to take up jobs or work more hours. Most recently, Henrik Kleven analyzed 27 state-level EITC expansions and all five federal EITC expansions. Using a synthetic control approach, Kleven found that none of the state-level expansions had any effect on employment. Kleven also found that only one of the five federal expansions—the 1993 EITC reform—is associated with any increase in the labor force participation of the single-mother target population. But that EITC reform coincided with new state-level eligibility restrictions for Aid to Families with Dependent Children and a booming macroeconomy. When those confounding factors are taken into account, Kleven shows the 1993 EITC reform also had no effect on labor force participation.

In addition to the dearth of historical evidence for the theory that the EITC boosts employment, there are two other complicating factors that policymakers should consider when contemplating the enactment of future EITC expansions or EITC copycat programs. The first factor is that there is no reason to believe that more and more EITC expansions will generate more and more employment boosts without limit. The second factor is that, when the labor market is demand-constrained (i.e., there are more jobseekers than job openings), as it has been for at least the last 21 years, the EITC’s enticements cannot increase overall employment, only change its composition. Thus, even in theory, pursuing EITC expansions in order to increase work may be futile in the current macroeconomy and at the current EITC benefit margin.
The claim that the EITC has a low administrative overhead is based on IRS reports that say EITC administrative costs are less than 1 percent of benefits delivered. Although the IRS does not detail how it derives this number, it is plausible. As mentioned already above, the EITC is administered through tax returns that are filed and processed through the existing IRS tax-filing infrastructure. There are no government offices, public social workers, or other costs generally associated with welfare programs.

The problem with this claim is that it ignores the enormous costs of the private tax preparation companies that actually administer a large share of the EITC benefits. Around tax time every year, tens of thousands of offices open up around the country to facilitate tax filings. These offices go by names like Liberty Tax Service, H&R Block, and Jackson Hewitt and they specifically concentrate in areas where people file for the EITC. Zip codes with the highest level of EITC filers have around 75 percent more tax preparers than moderate-EITC zip codes.

It is difficult to determine how much money these companies take in aggregate, but a 2016 survey found that preparers in the Washington DC and Baltimore areas charged anywhere from 13 to 22 percent of the average EITC refund. The IRS estimates that around 60 percent of all EITC returns are prepared by paid tax preparers. Taking the midpoint of the average tax preparation charge (17.5 percent) and multiplying it by the percent of EITC returns that use paid tax preparers (60 percent) reveals that the private administrative costs of the EITC program are 10.5 percent of benefits received. Adding that 10.5 percent to the IRS’s “less than 1 percent” produces a total EITC administrative cost of around 11 percent.

This 11 percent overhead makes the EITC one of the most inefficient welfare programs in the country.
To determine how much the EITC reduces headcount poverty, researchers run a couple of simple calculations using the Annual Social and Economic Supplement (ASEC) of the Current Population Survey (CPS). In the first calculation, they determine how many individuals have a disposable income that puts them below the poverty line based on the Supplemental Poverty Measure (SPM). In the second calculation, they do the same thing, but this time with the EITC subtracted from each person’s income. The difference between the two numbers, which was 5.6 million people in 2018, is then declared to be the number of people pulled out of poverty by the EITC.

If the underlying survey data is accurate, this is a good way of determining the number of people pulled out of poverty by a particular program. But there are three big problems with using this method in the case of the EITC.

**Wrong Year Problem.**
The CPS ASEC file counts EITC benefits that are received in one year as having been received in the prior year. For example, EITC benefits that were paid out by the IRS in early 2019 are counted in the CPS ASEC file as if they were received in 2018.

**Nonparticipation Problem.**
The CPS survey takers do not ask people how much money they received from the EITC. Instead, the CPS ASEC file reports an EITC value based on a tax model applied to each family’s reported earnings. This tax model assumes that everyone who is eligible for the EITC applies for and receives the benefit. In reality, only 78 percent of eligible people participate in the program.

**Tax Preparation Fee Problem.**
The CPS ASEC file does not reflect any reduction in benefits caused by paying tax preparation fees. Yet we know from above that around 60 percent of EITC filers pay these fees and that the fees range from around 13 percent to 22 percent of an individual’s EITC benefit.
In order to determine how much the standard measure overstates the poverty reduction caused by the EITC, I produced an alternative measurement that attempts to fix these three problems.

In order to fix the Wrong Year Problem, I linked individuals who were present in two consecutive years of the CPS ASEC. Due to the way that individuals cycle in and out of the survey, over any given two year period, around 25 percent of individuals are surveyed in both years. Restricting the sample to only those people allows you to replace the EITC values from each year’s CPS ASEC file with the EITC values from the prior year’s CPS ASEC file. So for example, when looking at the effect of the EITC in 2018, rather than using the EITC values in the 2018 CPS ASEC file, which reflect EITC benefits that were actually paid in early 2019, this approach uses the EITC values in the 2017 CPS ASEC file, which reflect EITC benefits that were actually paid in early 2018.

In order to fix the Nonparticipation Problem, I randomly selected 22 percent of the individuals who received the EITC in the CPS ASEC file and reduced their EITC benefit to zero. This reflects the percentage of eligible people who do not participate in the EITC, according to the IRS.

In order to fix the Tax Preparation Fee Problem, I randomly selected 60 percent of the remaining individuals who received the EITC in the CPS ASEC file and reduced their EITC benefit amounts by 17.5 percent. This reflects the percentage of EITC filers who use a paid tax preparer and the midpoint estimate of how much of each person’s EITC benefit is taken by a paid tax preparer.

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<th><strong>STANDARD MEASUREMENT</strong></th>
<th><strong>ADJUSTED MEASUREMENT</strong></th>
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<td><strong>BENEFIT YEAR</strong></td>
<td>Counts EITC benefits paid out in the subsequent year towards income in the current year.</td>
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<tr>
<td><strong>PARTICIPATION</strong></td>
<td>Assumes 100% participation.</td>
<td>Assumes 78% participation.</td>
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<tr>
<td><strong>FEES</strong></td>
<td>Assumes no fees.</td>
<td>Assumes 17.5% fees for the 60% of EITC filers who use paid tax preparation.</td>
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Applying the standard measure and the adjusted measure to the restricted sample of individuals who are surveyed in two consecutive years generates the results in the following graph.

Percentage Point Reduction in Poverty Rate Caused by EITC (2010–2018)

*Adjusting for year of disbursement, tax preparation fees, and non-participation halves the poverty reduction.*

On average, the standard measure shows that the EITC reduces the headcount poverty rate by 1.3 percentage points. For the alternative measure, it is 0.7 percentage points, which is about 47 percent lower.

This finding is consistent with a Census study published last year, which linked IRS administrative data to CPS data to determine the degree to which the CPS data overstates the poverty reduction caused by the EITC. That study found that the poverty reduced by the EITC is around 33 percent lower when using the IRS administrative data as compared to using the CPS data. However, that study only addressed the Nonparticipation Problem. It did not address the Wrong Year Problem or the Tax Preparation Fee Problem. Had it done so, it would have probably reached the same conclusion I have here.
Conclusion

The case for the EITC, which has hardened into a near-consensus in the left-of-center DC policy community, is largely built on myths and mismeasurements. The EITC has not historically increased employment or labor force participation and there is even less reason to believe that further EITC expansions from our current point would do so. The EITC is not an especially efficient program. In fact, it is among the least efficient welfare programs in the country once its unique private administrative costs are counted. Finally, the standard measurements of how much the EITC reduces head-count poverty are significantly inflated because those measures use EITC benefits from the wrong year, overstate program participation, and understate administrative costs.

The best way to expand the US welfare state going forward is not to enact more EITC-like measures, but to instead use more efficient and more effective universal programs. In the case of the EITC, that means replacing the EITC and the Child Tax Credit with a universal monthly child benefit administered by the Social Security Administration.14
Notes

1. See Policy Basics: The Earned Income Tax Credit
   🔄 https://www.cbpp.org/research/federal-tax/policy-basics-the-earned-income-tax-credit

2. Reducing Overpayments in the Earned Income Tax Credit

3. 10 Reasons to Love the EITC
   🔄 https://www.clasp.org/blog/10-reasons-love-eitc

4. RISE Act
   LIFT Act
   GAIN Act
   Working Families Tax Relief Act

5. Elaine Maag, Paying the Price? Low-Income Parents and the Use of Paid Tax Preparers
   🔄 http://webarchive.urban.org/UploadedPDF/411145_B-64.pdf

   Sum Delivery

7. For a general discussion of these information frictions, see page 8 of Henrik Kleven, The EITC and the
   Extensive Margin: A Reappraisal

8. Henrik Kleven, The EITC and the Extensive Margin: A Reappraisal

9. The Earned Income Tax Credit (EITC): Administrative and Compliance Challenges
   🔄 https://fas.org/sgp/crs/misc/R43873.pdf

10. The Price of Paying Taxes II: How paid tax preparer fees are diminishing the Earned Income Tax Credit (EITC)
        Price-of-Paying-Takes-II.pdf

11. Id.

12. Written Testimony of John A. Koskinen, Commissioner, Internal Revenue Service, Before the Senate Finance
    Committee on Regulation of Tax Return Preparers, April 8, 2014

CONT’D
Romney’s Charge That Most Federal Low-Income Spending Goes for “Overhead” and “Bureaucrats” Is False

Social Security Administrative Expenses
https://www.ssa.gov/oact/STATS/admin.html

CPS March Supplement
https://thedataweb.rm.census.gov/ftp/cps_ftp.html#cpsmarch

Policy Basics: The Earned Income Tax Credit
https://www.cbpp.org/research/federal-tax/policy-basics-the-earned-income-tax-credit

About EITC


See Family Fun Pack
https://www.peoplespolicyproject.org/projects/family-fun-pack/